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COMMENTARY ON THE BUSINESS PROFITS ARTICLE CONTAINED IN DOUBLE TAX TREATIES SIGNED BY IBERO-AMERICAN COUNTRIES

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Abstract: This is the first publication of a series of draft papers referred to the content of the Double Tax Treaties signed by Ibero-American countries, i.e. Latin American countries plus Brazil, Portugal and Spain. The present contribution refers to the business profits article, mostly patterned according to article 7 of the OECD Model Tax Convention, from which it departs to give an overview of the scope, rationale and purpose of this provision, as well as relevant deviations from such a modelled reference.

Keywords: International taxation, double tax treaties, OECD model tax convention, OECD model deviations, Ibero-America tax policy, business profits.

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1. INTRODUCTION

1.1. OVERVIEW

The distribution of taxing powers on business profits at the international level is has been traditionally based on the benefit principle, according to which if a non-resident accomplishes a certain threshold presence in a State, it is considered that a sufficient economic allegiance exists to legitimate the taxation of profits derived from its activity, as it enjoys the services the State provide in its territory[2]. Since the consensus achieved by the international community in the first half of the twentieth century on the fact that such allocation key must mainly refer to physical presence, the "permanent establishment" (PE) notion within Double Tax Conventions (DTCs) has been paramount to evaluate such degree of attachment. Therefore, if according to the requisites provided by applicable law, an alien has a PE at its disposal, the source State (the State in which the permanent establishment exist) will be entitled to tax those profits that are attributable to it. Indeed, the whole the Ibero-American DTC network follows such approach[3], with the sole exception of the Andean Community DTC[4] and the DTC signed between Argentina and Bolivia[5], that follow a pure source rule on business profits.

This framework is replicated in almost every DTC in force nowadays. The OECD, UN and US Model Tax Conventions also follow it in the rules on the distribution of taxing powers on business profits[6]. Besides, many States use the PE concept in their domestic law to assimilate the tax treatment of the profits that are attributable to it to the taxation

[2] See SKAAR, A. (1991) *Permanent Establishment. Erosion of a Tax Treaty Principle* (Deventer: Kluwer Law and Taxation Publishers), p.27-29. ESCRIBANO LÓPEZ, E. (2015) "An Opportunistic, and yet Appropriate, Revision of the Source Threshold for the Twenty-First Century Tax Treaties" (Intertax, vol.41, n.1, p.6-13), p.7-8.

[3] The Ibero-American DTC network comprises more than 420 treaties in force, plus the Andean Community DTC. Please note that this paper was drafted taking into account DTCs in force in December 30th, 2018.

[4] "Art.6 Business Profits" of the Decision 578 of the Andean Pact: "Profits resulting from entrepreneurial activities may only be taxed by the Member State in which they take place". Notwithstanding, if an enterprise performs business activities in two or more states, the arm's length principle is adopted to attribute profits to determine the amount each jurisdiction may tax.

[5] Art.7 states: "Profits resulting from business activities shall be taxable only by the Contracting State in which such business activities have been carried on. Where an enterprise carries on activities in both Contracting States, each of them may tax the income, gains or profits derived from within its territory. An enterprise of one of the Contracting States shall not be deemed to be carrying on activities in the other Contracting State by virtue of the mere fact that it does business in that last-mentioned State through a broker, commission agent or other independent agent acting in the normal course of his activities"

[6] Art.7.2 OECD 2014 MTC, art.7.2 UN 2011 MTC, art.7.2 2016 US 2016 MTC.

of profits of resident enterprises. This notion may also be found within DTCs, envisaged in the non-discrimination provision[7].

Art.7 deal with the allocation on taxing powers referred to business profits. This article has been one of the most stable ones within the UN MTC, i.e. the wording has remained practically the same throughout the years. Also, in the OECD MTC, the configuration of the provisions within the article has remained unchanged up until 2010, when a comprehensive review of its content took place. Despite this fact, the rationale of the new and the old version of art.7 remained the same, as it will be shown below. In that sense, it may be affirmed that the underlying logic of the article has endured stable since the first OECD MTC came into light.

Almost all the DTCs signed between Ibero-American countries with their treaty partners worldwide are based on the structure of the OECD pre-2010 MTC version of art.7. Indeed, a significant number of DTCs plainly follow the wording of the OECD pre-2010 MTC version of art.7[8]. It is structured as follows:

- Art.7.1 determines that the residence States has taxing rights over business income. Nonetheless, if a PE exist in the other State in accordance with the definition provided in the Convention (art.5), profits attributable to it may be taxed in that other State.
- Art.7.2 introduces the "functionally separate enterprise" notion that is paramount to attribute profits to PEs. The content of such fiction is analyzed below in section 2.1.
- Art.7.3 allows the deduction of expenses incurred for the purposes of the PE.

[7] Art.24.3 of the OECD states: "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities". The wording is the same as the one envisaged in art.24.3 UN 2011 MTC and art.24.2 US 2016 MTC.

[8] Treaties of **Bolivia** (with France, Germany, Spain, Sweden and the United Kingdom), **Brazil** (with China), **Chile** (with Austria, Belgium, Colombia, Croatia, Denmark, Ecuador, Ireland, Italy, Norway, Paraguay, Peru, Portugal, Russia, South Africa, Switzerland and Thailand), **Colombia** (with Chile, Czech Republic, Mexico and Switzerland), **Cuba** (with Barbados, China, Portugal, Russia and Spain) **Dominican Republic** (with Spain), **Ecuador** (with Belgium, Chile, China, France, Italy, Romania, Singapore and Switzerland), **El Salvador** (with Spain), **Mexico** (with Colombia, Germany, Hungary, Japan and Switzerland), **Panama** (with Czech Republic, France, Ireland, South Korea, Luxembourg, Netherlands, Portugal, Singapore, Spain and the United Arab Emirates), **Paraguay** (with Chile), **Peru** (with Chile and Switzerland), **Portugal** (with Bahrain, Chile, Croatia, Cuba, Cyprus, Czech Republic, Estonia, Georgia, Germany, Guinea-Bissau, Hong Kong, Iceland, Israel, Italy, Latvia, Lithuania, Luxembourg, Macau, Malta, Moldova, Morocco, Netherlands, Pakistan, Panama, Poland, Qatar, Romania, Russia, San Marino, Singapore, Slovak Republic, Slovenia, Switzerland, Tunisia, Ukraine and the United Arab Emirates), **Spain** (with Armenia, Bolivia, Croatia, Cuba, Cyprus, Czech Republic, Dominican Republic, El Salvador, Finland, France, Hong Kong, Hungary, Iceland, Iran, Ireland, Israel, Jamaica, Luxembourg, Macedonia, Malta, Pakistan, Panama, Poland, Romania, Senegal, Slovak Republic, Slovenia and Switzerland), **Uruguay** (with Hungary, Luxembourg, Portugal and Switzerland) and **Venezuela** (with Belarus, Belgium, France, Germany, Italy, Netherlands, Sweden and Switzerland).

- Art.7.4 refers to the applicability of apportionment methods. As demonstrated in section 2.2., this provision is meaningless due to the fact that the outcome must be in accordance with the "functionally separate enterprise" parameter.
- Art.7.5 leaves out of the calculation of the profits attributable to PEs, those that arise by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.
- Art.7.6 calls for the application of the same method to attribute profits to PEs year by year. Notwithstanding, as per art.7.4, this is an empty provision, as necessarily the only method to allocate profits that will always be used is the "functionally separate enterprise" one.
- Art.7.7 determines the prevalence of the articles of the Convention that refer to specific items of income over art.7.

Only two DTCs signed by Panama adopted the new 2010 OECD version of art.7[9].

The exact wording of the UN MTC was followed only by the DTC signed between Panama and Vietnam. Particularities arising from this Model, as compared to the OECD one, are the following:

- A limited force of attraction rule is included in art.7.1.
- Limitations on certain expenses are envisaged in art.7.3.
- There is no provision equivalent to art.7.5 commented before, albeit the UN included a note in which it recommends the States to consider its inclusion during negotiations.

Many omissions and/or variations to the language present in both models have been introduced by the signatory States. Some are referred to modifications introduced in UN MTC specific clauses, i.e. the force of attraction one and the limitation of expenses one. Other are not based in any of the provisions envisaged in either of the commented models, i.e. clauses referred to the scope of art.7, insurance clauses, anti-deferral clauses, provisions referred to the definition of the term "profits", as well as other clauses. All these deviations will be mentioned and analyzed below.

1.2. A BRIEF HISTORICAL BACKGROUND ON THE PROVISION

As it is well known, in the framework of the League of Nations, during the 1920s and the first half of the 1930s, the foundations of the principles informing international taxation and double taxation conventions were established along several reports and model conventions elaborated by experts at that time, in accordance with business reality and the willing of the States that formed part of such organization. The issue of how to allocate taxing powers on business income generated by an undertaking operating in two or more

[9] Treaties of **Panama** (with Israel and the United Kingdom).

countries was probably the most challenging one, as this item of income was the most relevant in cross-border scenarios and the use of wholly owned subsidiaries was neither prevalent, nor legally possible, in many countries[10].

The dawn of such a process took place when, in 1922, seven officials from European countries were appointed to analyze the issues of double taxation and tax evasion. This group released a report and resolutions which contained certain guidance on how to tax income derived from permanent establishments[11] -although such naming was not already in use-. It was stated that:

> "If the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative, each one of the contracting States shall tax that portion of the net income produced in its own territory. Therefore, the financial authorities of the interested States shall be able to request the taxpayer to hand in general balance-sheets, special balance-sheets and all other relevant documents"[12].

Therefore, as soon as in 1925, the rationale of current distribution rules on business profits was enclosed in issued recommendations on the subject matter. Some sort of presence in the State of origin (source) was already required. Also, the resolution suggested the adoption either of a tax credit or exemption on the State of residence of the undertaking to relieve double taxation. As regards the method to attribute profits to permanent establishments, the issue was defined as the most difficult one the reporters had to face. The use of separate accounting books was proposed, probably inspired by the solution adopted in the Czechoslovakia-Italy Income Tax Treaty (1924)[13]. Also, a reference to formulaic methods based on relevant pointers that depended on the performed business activity was included.

Later on, in 1927, a report elaborated by officials from 12 countries that resulted in the Draft of a Bilateral Convention for the Prevention of Double Taxation was presented. As regards business income, the accounting-based method proposed in 1925 was adopted, albeit apportionment rules were endorsed for those cases in which the accounts of the enterprise were not available. Art.5 of the mentioned model convention provided:

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[10] SASSEVILLE, J.; VANN, R. (2014) "Commentary on article 7" /in/ VANN, R. (ed.) *Global Tax Treaties Commentaries* (Amsterdam: IBFD), section 1.2.1.1.

[11] See *League of Nations: Technical Experts to the Economic and Financial Committee Double Taxation and Tax Evasion Report and Resolutions submitted by the Technical Experts to the Financial Committee Document F.212*, February 1925.

[12] Ibid. *Resolution I-C*, at p. 31.

[13] SASSEVILLE, J.; VANN, R. (2014) "Commentary on article 7", section 1.2.1.3.3.

> "1. Income from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the persons controlling the undertaking or engaged in the trade or profession possess a permanent establishment.
> ...
> 3. Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory.
> 4. In the absence of accounts showing this income separately and in proper form, the competent administrations of the two Contracting States shall come to an arrangement as to the rules for apportionment."

In 1928, the General Meeting of Government Experts on Double Taxation and Tax Evasion took a step back on the support for accounting and instead preferred the apportionment method as agreed by the involved Contracting States. Notwithstanding, the solution was not entirely satisfactory, as once again there was a recommendation to appoint a group of experts representing different legal and tax systems to approach the issue.

In 1929, the Fiscal Committee of the League of Nations issued a questionnaire on attribution of profits to member countries. In 1930, answers were studied and it was agreed that a thorough study was needed. Thereafter, a Rockefeller Foundation grant was conceded to Mitchell B. Carroll, who visited up to 27 countries and addressed the issue, among many others, in a five-volume report[14]. This work forms the basis for the elaboration by the mentioned Committee of a Multilateral Convention model "for the Allocation of Business Income between States for the Purposes of Taxation", issued in 1933. Art.1 of this document contained the relevant rule on business income:

> "An enterprise having its fiscal domicile in one of the Contracting States shall not be taxable in another Contracting State except in respect of income directly derived from sources within its territory and, as such, allocable, in accordance with the articles of this Convention, to a permanent establishment situated in such State".

[14] See the work of Mitchell B. Carroll and Ralph Jones on the subject matter: CARROLL, M.; JONES, R. (1932 -1933) *Taxation of Foreign and National Enterprises, vols. 1-3* (League of Nations). CARROLL, M. (1933) *Volume 4. Methods of Allocating Taxable Income*, (League of Nations) and JONES, R. (1933) *Volume 5 Allocation Accounting for the Taxable Income of Industrial Enterprises* (League of Nations). CARROLL recommended that PEs should be treated "in so far as possible as independent entities, in order that the income allocated to a branch may be equivalent to that which would have been derived by an independent enterprise.". See VANN, R. (2006) "Tax Treaties: The Secret Agent's Secrets" (British Tax Review, n.3, p.345-382), p.364. KOBETSKY, M. (2011) *International Taxation of Permanent Establishments* (Cambridge: Cambridge University Press), p.194.

On the other hand, art.3 contains a provision on the attribution of profits to permanent establishments:

> "If an enterprise with its fiscal domicile in one Contracting State has permanent establishments in other Contracting States, there shall be attributed to each permanent establishment the *net business income* which it might be expected to derive if it were an *independent enterprise engaged in the same or similar activities under the same or similar conditions*. Such net income will, in principle, be determined on the basis of the *separate accounts* pertaining to such establishment. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated" (emphasis added).

The project was not successful and was abandoned in 1935, when countries agreed on a framework based on bilateral conventions. In both the multilateral and bilateral models, only business profits attributable to PEs could be taxed at source, according to the separate accounts pertaining to such establishment. Also, empirical -apportionment-methods were allowed in the absence of accounts that can be appropriately adjusted, or with the agreement of the enterprise. According to SASSEVILLE and VANN, the first treaties to incorporate such a rule were the DTC between Canada and the United States (1942) and the DTC between the United Kingdom and the United States (1945).

Albeit the Mexico Model of 1943 contained a source-based rule for business profits - unless these resulted from "isolated or occasional transactions"-, this approach was later rejected in the London Model, in which the separate enterprise principle based on the attribution of profits to permanent establishments was again adopted. The next development on the subject matter took place under the aegis of the OEEC Fiscal Committee, where a "Report on the Allocation of Profits to Permanent Establishments and Subsidiary Companies" released in 1960 formed the basis for article 7 of the 1963 OECD Draft Model Convention. Article 7 of the 1963 draft convention provided:

> "1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
> 2. Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a perm- anent establishment.

> 3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establish- ment is situated or elsewhere."

This provision remained practically unchanged until the OECD 2010 MTC was released, being the only variation a minor one, namely, the inclusion of the words "subject to the provisions of paragraph 3" at the beginning of article 7.2 in the 1977 model. From that moment onwards, significant changes were introduced in the Commentaries that alter mainly the recognition of expenses and the methodology to calculate profits attributable to a PE, to approximate its treatment to that of independent enterprises. As the present contribution does not focus on the analysis of the content of the Commentaries, it is considered that the simple mention of the reports should suffice for the purposes of the present section[15]. In particular, the following milestones may be quoted:

1. 1994: report Attribution of Income to Permanent Establishments, incorporated into the 1994 version of the OECD MTC Commentaries.
2. 2001: discussion draft on general topics (Part I) and topics referred to the PEs of banking enterprises (Part II).
3. 2003: discussion drafts of a revised version of Part II and of a new Part III dealing with PEs of enterprises carrying on global trading of financial instruments.
4. 2004: discussion drafts of revised versions of the described Parts I, II and III;
5. 2005: discussion draft of Part IV dealing with PEs of insurance companies;
6. 2006: final versions of Part I, Part II and Part III.
7. 2007: new version of Part IV.
8. 2008: final version of the OECD Report on the Attribution of Profits to Permanent Establishments which included slightly modified versions of Parts I, II, III and IV. Also, that year, changes were adopted in the new version of the Commentary on Article 7 of the OECD MTC;
9. 2008: publication as a discussion draft of a proposed new article 7 of the OECD Model and changes to the Commentary on Article 7 of the OECD Model;
10. 2009: discussion draft of a revised version of the new article 7 of the OECD Model and changes to the Commentary on Article 7 of the OECD Model.
11. 2010: adoption of the new version of article 7 and changes to the Commentary on Article 7 of the OECD MTC, together with an updated version of the accompanying report which reflected the changes made to article 7 of the OECD Model.

According to the OECD, the modification of the wording of art.7 in the OECD 2010 MTC had to take place because that the content of the mentioned reports went beyond the

[15] For an in-depth analysis on the subject, see RUSSO, R. (2006) "Report on the historical development of article 7 of the OECD model" /in/ *The Attribution of Profits to Permanent Establishments* (IFA Cahiers de droit fiscal international, p.89-108).

content of the pre-2010 version of this provision[16]. Notwithstanding, as it will be sustained below, there is no reason to interpret the new version of art.7 differently from the prior version, which actually constitutes the basis of almost all DTCs signed within the Ibero-American network.

On the side of the UN, an *ad hoc* Group of Experts on Tax Treaties between Developed and Developing Countries was conformed in 1967. Before the first UN MTC was released in 1980, the "Guidelines for Tax Treaties between Developed and Developing Countries" and the "Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries" already contained certain mentions to the issue of allocation of taxing powers on business income. The proposals were included in the referred Model and remained unchanged since then. Neither the UN 2011 MTC nor the 2017 version reflect the review of the wording of art.7 undertaken by the OECD.

[16] OECD (2010) *Report on the Attribution of Profits to Permanent Establishments*, par.5 et seq. SASSEVILLE, J.; VANN, R. (2014) "Commentary on article 7", section 1.2.3.3.

2. RATIONALE OF THE ATTRIBUTION OF PROFITS IN THE OECD AND THE UN MTCs

2.1. THE ARM'S LENGTH STANDARD AS THE BENCHMARK TO ATTRIBUTE PROFITS TO PEs

Once the existence of a PE according to the definition of art.5 has been ascertained, the truly relevant content of art.7 consists in the attribution of profits to it, to quantitatively determine the source State power to tax in the case of business profits. Therefore, the correct attribution is crucial to correctly determine the tax burden that an alien enterprise must bear in the State in which a PE exist[17]. Although many approaches exist to appraise the issue, the most widespread consists in treating the PE as if it were a functionally separate entity[18], independent from its head office[19]. The profits generated due to the commercial and financial relations performed by the PE with third parties and the rest of the parts of the enterprise -other PEs and the head office-[20] should be attributed to it. This fiction emulates the separate enterprise notion that governs corporate taxation since the raise of modern tax systems in the dawn of the twentieth century, namely the taxation of profits that each enterprise individually obtains, even if the enterprise is integrated in a group. An indispensable accompaniment is the arm's length principle, that determines the need to perform valuation adjustments to related parties' transactions as to resemble the outcome independent parties would have agreed on under identical or quite similar circumstances[21].

As a consequence of the adoption of the separate enterprise principle, the rules on attribution of profits to PEs and transfer pricing rules are quite similar[22], as the former are based on the latter. As a matter of fact, this resemblance makes perfect sense if one departs from a neutrality perception, this is, from the idea that the tax treatment of foreign direct

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[17] The reference to the adequate attribution of profits must be read as well as referring to the adequate attribution of losses. See in the same vein, OECD (2010) *Report on the Attribution of Profits to Permanent Establishments*, par.3.

[18] OECD (2010) *Report on the Attribution of Profits to Permanent Establishments*, par.50. BAKER, P.; COLLIER, R. (2006) "General Report" /in/ *The Attribution of Profits to Permanent Establishments* (IFA Cahiers de droit fiscal international), p.26.

[19] The "separate enterprise" concept has remained unchanged since the very first time it was formulated, see SASSEVILLE, J; VANN, R. (2016) "Article 7: Business Profits", p.37.

[20] BENNET, M.; RUSSO, R. (2009) "Discussion Draft on a New Art. 7 of the OECD Model Convention" (International Transfer Pricing Journal, vol.16, n.2, p.73-80), p.76.

[21] See Art.9.1 OECD 2014 MTC, art.9.1 UN 2011 MTC, art.9.1 US 2016 MTC.

[22] SASSEVILLE, J.; VANN, R. (2014) "Commentary on article 7", p.4.

investment through subsidiaries or through PEs should receive the same treatment[23]. Notwithstanding, there will always be differences within tax law related to the choose of either alternative[24], as a subsidiary has legal personality and full capacity to act and conclude contracts that may entail the segregation between functions, assets and risks, whereas the PE, by definition, cannot perform such tasks. For instance, if a PE uses a tangible asset to perform entrepreneurial functions, normally it will not be considered that such use derives from a deemed leasing agreement with the head office[25], but the economic ownership will be exclusively attributed to the PE and therefore, there would be no need for deemed payments derived from the use of the asset to take place. On the other hand, in a parent-subsidiary scenario, a leasing agreement could be perfectly possible, i.e. the subsidiary could enjoy the asset while the parent would remain as the formal owner, and payments on the use should be performed in this scenario. In this latter case, the content of the written agreement is paramount, being this element inexistent in the case of a head office-PE scenario.

Besides, there are other relevant differences that should be taken into account. First, both the head office and the PE share the very same credit rating[26], while a parent and its subsidiaries may display dissimilar creditworthiness and thus, be not equally positioned to access to financial markets[27]. Second, it is not possible for a PE to guarantee the debt attributable to the head office nor *vice versa*[28], while in a parent-subsidiary setting it is. Third, capitalization needs of a subsidiary compared to those of a PE are quite different. A subsidiary usually must comply with regulatory requirements posed in non-tax regulations, while the PE is not constrained by the same limitations to decide upon its

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[23] DZIURDZ, K. (2014) "Attribution of Functions and Pro ts to a Dependent Agent PE: Different Arm's Length Principles under Articles 7(2) and 9?" (World Tax Journal, vol.6, n.2, p.135-167), p.145. MALHERBE, J. DAENEN, P. (2010) "Permanent Establishments Claim Their Share of Profits: Does the Taxman Agree?", p.361. BLACK, A. (2010) "Attribution of Profits to PEs – Implications of the 'Authorized' OECD Approach (Part 1)" (Journal of International Taxation, Vol.21, n.2, p.19-29, 62-64), p. 20.

[24] SASSEVILLE, J.; VANN, R. (2014) "Commentary on article 7", p.8. BAKER, P.; COLLIER, R. (2006), p.26.

[25] Cfr. SCHNITGER, A. (2013) "Comments on the Klaus Vogel Lecture – Problems Arising under Domestic Tax Law Due to the Introduction of the Authorised OECD Approach" (Bulletin for International Taxation, vol.67, n.4/5, p.211-215), p.213.

[26] OECD (2008) Report on the Attribution of Profits to Permanent Establishments, par.36, 132.

[27] See YONG, S.Y. (2012) "Tax Optimization Using Branches?" (Bulletin for International Taxation, vol.66, n.8, p.424-435), p.427. All in all, the creditworthiness of a subsidiary may be increased due to the fact that the one of its parent company is higher. This effect is known as passive association. See *OECD 2015 Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, par.1.157 et seq. See *The Queen v. General Capital Canada Inc. (2010) FCA 344* (Canadian Federal Court of Appeals). See BOIDMAN, N. (2011) "Pricing Canada-U.S. Guarantees After GE Capital: Still Evolving" (Tax Management Transfer Pricing Report, vol.19, n.19, p.1042-1051), p.1044. LINDSAY, P.; POON, C. (2014) "Transfer Pricing in Canada: Maturing Jurisprudence will Guide the Next Wave of Disputes" (Transfer Pricing International Journal, vol.15, n.7, 6 p.), p.3.

[28] OECD (2008) *Report on the Attribution of Profits to Permanent Establishments*, par.36, 134, 135.

finance structure. Fourth, a PE does not have shareholders, a subsidiary does[29]. Fifth, the outcome of transactions agreed by a parent and a subsidiary has implications beyond tax law, while the deemed agreements between the PE and the head office are irrelevant out of that field, as the PE notion constitutes a fiction created only for tax purposes[30].

Other relevant difference derives from the wording of art.7 as envisaged in the UN MTC and the pre-2010 OECD MTCs, which -as already stated- serve as reference for almost the entire Ibero-american DTC network. The nuance has to do with losses recognition. While in the 2010 OECD MTC version of art.7 an enterprise could display losses in aggregated terms, but could obtain profits at the level of the PE -profits that could be taxed by the State in which it is present-, in the former mentioned models the taxation of profits within the PE is not possible if the enterprise as a whole displayed losses in a given taxable period [31].

Therefore, the rules on attribution of profits to PEs may be tailored to approximate the tax treatment of a PE to that of a subsidiary, but a complete alignment cannot take place[32]. In fact, some authors doubt on whether the assimilation of both regimes is desirable from the perspective of the equality principle, as both scenarios are not comparable due to the reasons explained in the prior paragraph[33].

Under the described framework, it is appropriate to pinpoint some relevant aspects on the attribution of income to PEs, as to briefly describe its content. The allocation of taxing powers within DTCs is normally referred to items of income, to qualification issues, but not to valuation matters referred to the calculation of the taxable base[34]. Nonetheless, the rules on attribution of income to PEs are a clear exception to such general standard, as

[29] BURGERS, I. (2009) “The New OECD Approach on Profit Allocation: a Step Towards Neutral Treatment of Permanent Establishments and Subsidiares”, p.73.

[30] MOERER, O.; KLAVER, B. (2015) “The AOA, PE status and BEPS, some reassurance in a time of change?” (Transfer pricing international journal, vol.16, n.4), p.1590.

[31] See OECD (2010) *Report on the Attribution of Profits to Permanent Establishments*, par.8. BURGERS, I. (2009) “The New OECD Approach on Profit Allocation: a Step Towards Neutral Treatment of Permanent Establishments and Subsidiares” (Florida Tax Review, vol.10, n.1, p.51-76), p.59. OOSTERHOFF, D. (2008) “The True Importance of Significant People Functions” (International Transfer Pricing Journal, vol.15, n.2, p.68-75), p.69. BENNET, M.; RUSSO, R. (2007) “OECD Project on Attribution of Profits to Permanent Establishments: An Update” (International Transfer Pricing Journal, vol.14, n.5, p.279-284), p.279. KOBETSKY, M. (2011) *International Taxation of Permanent Establishments*, p.198-199.

[32] MALHERBE, J. DAENEN, P. (2010), p.361. BERNALES SORIANO, R. (2013) “The Authorized OECD Approach: An Overview” /in/ GUTIÉRREZ, C.; PERDELWITZ, A. (eds.) Taxation of Business Profits in the 21st Century (Amsterdam: IBFD, p. 135-181), p.12.

[33] PANAYI, C. (2013) “The Taxation of Permanent Establishments: Selected Issues” (Bulletin for International Taxation, vol.67, n.4/5, p.226-237), p.229 express the same doubts in the context of the CJEU case law on the subject matter.

[34] That said, it has be mentioned that transfer pricing rules may cause an impact in the allocation of taxing rights in those cases in which a jurisdiction performs adjustments within items of income if such adjustments entail a requalification outcome from the perspective of the DTC allocation rules, i.e. arts. 6 to 21.

the resulting figure entails a limitation for the source jurisdiction to tax PEs business income, and constitutes a reference for the residence jurisdiction to appropriately eliminate double taxation.

DTC attribution rules are applicable autonomously, as their aim is to determine the profits that are to be allocated to a PE as a concept defined in the very same Convention. Consequently, in order to ascertain the tax treatment of business income, it will always be necessary to also apply domestic rules on the determination of the taxable base where the EP lies. If the amount of profits determined by domestic rules is higher than the amount that results from attribution rules at the DTC level, the latter will act as a barrier. If, on the contrary, the amount is lower, the DTC limit will not play a role. This rationale is similar to that of percentage limits normally used in the context of passive income, although applied in the context of the calculation of the taxable base, instead of the taxable rate.

The separate enterprise principle is quite a generic parameter that must be concretized. To that effect, along many decades, the OECD has published a series of recommendations that many States have followed not only to interpret and apply the article referred to business profits in their DTC network, but also to implement domestic rules on the subject matter. The referred guidelines have been sharpen over the years, as the OECD approached the issue more and more deeply through the publications of various reports, the content of which has impacted the interpretation of the "functionally separate enterprise notion" over time. While in the section referred to the historical background, the referred reports were mentioned, hereby two aspects will be underscored as the main drivers of change on the viewpoint of the OECD.

On the one hand, it relevant to emphasize that the methodology to allocate profits to PEs has evolved from a mere accounting analysis to a thorough examination of functions, assets and risks attributable to the PE, being these elements the ones that, at the end of the day, define the functionally separate enterprise fiction in accordance with its economically relevant characteristics. To this analysis, a second stage is added by which the revenues and expenses derived from deemed agreements between the PE and its home office, other parts of the enterprise, or transactions with third parties are taken into account. In this phase, the arm's length standard notion is paramount. This two-stage methodology has been labelled as the "Authorized OECD Approach" (AOA).

That said, the AOA does not entail a breach with the former approach -based on the accounting of the PE-, but an improvement and refinement of it[35]. The difference between both strands lies in the fact that guidance on the enforcement of the AOA are fairly more detailed and specific than a generic reference to accounting. Indeed, the use of accounting

[35] In the same vein, see BENNETT, M. (2008) "The Attribution of Profits to Permanent Establishments: The 2008 Commentary on Art. 7 of the OECD Model Convention" (European Taxation, vol.46, n.1, p.467-471), p.469.

records has to be based in real facts, as the AOA does, and therefore both should lead to the same result. Indeed, the attribution of functions, assets and risks is of great aid to ascertain whether the accountings of a PE reflect real facts or are inaccurate or incorrect in that regard[36]. Therefore, if the documentation prepared by the taxpayer correctly reflects the existing functions performed, assets used and risks assumed, as well as the outcome of the dealings with the rest of the enterprise and third parties, the resulting allocation of profits should be respected[37]. It is therefore easy to ascertain the importance of documentation both in a parent-subsidiary setting and that of a head office and a PE. Indeed, coherence demands for PEs to be required to fulfill the same -or very similar- accounting duties as resident enterprises bear[38].

On the other hand, the methodology proposed by the OECD has significantly evolved in what concerns the recognition of deductible expenses by the PE. The former approach, based on restrictions on the deduction of expenses on deemed dealings between the PE and the head office has been abandoned in favor of an almost complete alignment on the treatment of PEs and subsidiaries. For instance, the OECD 1963 MTC Commentaries stipulated that the deduction of deemed royalties or interest payments to the head office were not to be allowed, nor payments to compensate costs derived from management or auxiliary services should. In fact, it was admitted that such approach was a departure from the wording of the provision on business profits proposed in the Model.

It is certainly inadequate to limit the recognition of expenses without normative support whatsoever. Indeed, the configuration of the provision on business profits throughout the MTCs elaborated by the OECD do not constraints in that regard. Moreover, the very OECD implicitly admitted the wrongfulness of its former position due to the changes in interpretation along various reports, referred to a rule the wording of which has not varied since the first OECD MTC was released. This is a clear indicator of the fact that the former position was sustained not as a sensible interpretation of the rule, but because other reasons more related to the preservation of the taxable base of the jurisdiction of the PE, i.e. due to collection reasons. In this sense, the review on the described approach is certainly positive, as it lowers the tension of recommendations based not in a logical approach to the configuration of the business profits article, but on goals external to that element. Indeed, if the aim was to restrict deductions, the OECD could have established

[36] In the context of transfer pricing rules, the importance of documentation within the fact assessment stage is important to build a solid point of departure in that regard. See TPG-2010 par.1.52-1.53. OECD (2014) *BEPS Actions 8, 9 and 10. Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, And Special Measures)*, par.2, 3. OECD (2015) *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*, par.1.42-1.43.

[37] BIRNKRANT, H. (2004) "Through the Looking Glass: the OECD Discussion Draft Treatment of a Permanent Establishment as a Functionally Separate Entity" (Tax Management Memorandum), p.127.

[38] Cfr. DZIURDZ, K. (2014) "Attribution of Functions and Pro ts to a Dependent Agent PE: Different Arm's Length Principles under Articles 7(2) and 9?", p.142.

so in the text of the provision, as the UN Model and many DTCs from the Ibero-American network do[39].

Therefore, the methodology proposed by the OECD from 2008 onwards, namely the AOA approach, entails a clear progress if compared to the prior guidance, as it develops more sophisticated criteria to regard the PE as a functionally separate entity and abandons the illogical position maintained on the deductibility of expenses under the described terms. This continuum between the former approach and the new one is a key aspect, as it permits to consider that each DTC that follows the logic and structure of art.7 as drafted in its current OECD 2014 MTC version, the OECD pre-2010 version and the current UN MTC one can be uniformly interpreted on what regards the attribution of income to PEs. Of course, many DTCs introduce nuances that will be described below, but the departure point is clearly the same[40], irrespective of the signature date of each DTC.

Notwithstanding, the issue of the recourse to the AOA to correctly interpret art.7 of the Ibero-American DTC network will be dealt with. As stated in the section devoted to the historical development of art.7, in 2008, the Committee on Fiscal Affairs (CFA) published the report in which the AOA methodology was proposed to be incorporated in the OECD MTC Commentaries in two stages. The first stage consisted in the introduction of the conclusions of the report within the Commentary on art.7 of the OECD 2008 MTC. The second one consisted in the modification of the wording of art.7 and the inclusion of additional comments on this newly drafted provision, within the framework of the OECD 2010 MTC. Curiously enough, the OECD did not remove the 2008 comments, because the majority of DTCs in force at that time were drafted in accordance with the former wording (pre-2010) and indeed, almost none of the newly negotiated DTCs have been drafted using the 2010 wording of art.7. Actually, as stated before, within the entire Ibero-American DTC network, only two DTCs signed by Panama include such provision[41].

Under the described framework, it has been proposed that the AOA methodology should only be applied to those DTCs signed after the OECD 2008 MTC Commentaries were released. Truth is that such approach is incorrect due to the following reasons.

First, there is no breach in the rationale of the former methodology and the AOA one, as previously explained. Therefore, it is irrational to draw a distinction if both must lead to the same exact result.

Second, to link the use of the OECD MTC Commentaries to a date referred to the negotiation or signature of DTCs entails the recognition of an authorized interpretative value to a non-binding source of interpretation without any justification whatsoever.

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[39] See section 3.2.

[40] The only exceptions are the Multilateral tax convention of the Andean Agreement and the DTC in force between Argentina and Bolivia.

[41] Treaties of **Panama** (with Israel and the United Kingdom).

Although the issue of the interpretative value of soft law in this context constitutes a relevant debate that merits to be treated in depth, due to the fact that this topic is not directly related to the aim of the present contribution, the following brief remarks should be enough to support the Commentaries should not have a privileged status over other non-binding sources: (1) this instrument lack publicity and the accessibility that should comply with any legal rule promulgated on a rule of law jurisdiction (2) the Commentaries are not ratified by a democratic institution. This soft law tool is elaborated by the Committee on Fiscal Affairs (CFA), which is composed of tax administrations' representatives of OECD Member States (3) the definitive approval of the final document takes place on the OECD Council as a recommendation, i.e. as a non-binding instrument. The OECD member States are the ones that decide, each time a new version of the Commentaries is released, for it to be non-binding. For all these reasons, the version of the Commentaries that should be used to interpret art.7 is the one that suits best its wording and rationale, in accordance with the limits posed by the very possible meaning of its terms.

Third, art.7.2 is, in both the OECD pre-2010 version and the 2010 one, equally ample in its setting. The analysis based on functions, assets and risks can be extrapolated to either texts, being this a positive aspect, as the AOA approach constitutes the most accurate methodology on the implementation of the arm's length principle in the PE context[42]. In fact, it is easy to ascertain that the wording of each version is almost undifferentiated and identical in its content. The 2010 version includes an explicit reference to functions, assets and risks while the pre-2010 one does not, but can be inferred from the reference to the performance of an independent enterprise "under the same or similar conditions", which involves the analysis of the substance of the PE as a separate business unit that perform concrete tasks through given means. In this sense, the attribution of functions, risks and assets lead to adequately shape the PE as if it were a distinct and separate enterprise, because no other elements exist apart from the mentioned three that could be relevant to determine the amount of income a PE would have obtained by its own.

The unitary approach sustained in these lines -apart from the nuance referred to losses recognition that has been already commented- leads to assume that, unless other rules establish exceptions to the commented methodology, both the domestic rules and the DTC ones tailored in accordance with the arm's length notion as applied in the framework of allocation of income to PEs will often lead to a very similar result, which would be the one resulting from the guidance determined by the AOA rationale. Thereby, possible conflicts due to mismatches are avoided.

The counterweight to all the aforementioned is that the AOA methodology must always respect the notion of "functionally separate entity" as reflected in art.7.2. The AOA constitutes a suitable mean to interpret such an ample and diffuse criterion, but it cannot

[42] In the same vein, see OSTERHOFF, D. (2008) "The True Importance of Significant People Functions", p.73.

exceed or contravene its content. Notwithstanding, it is not the purpose of this contribution to delve into possible queries that may arise from the commented interconnection.

From the next section onwards, deviations from the OECD and the UN models will be commented in depth. The force of attraction and the limitation of expenses sections are referred to modifications over the wording of UN provisions. The rest of the sections reflect clauses that are not based in any of the provisions envisaged in either of the commented models.

2.2. ADMISSIBILITY OF APPORTIONMENT METHODS

According to art.7.4 of the 2008 and prior OECD MTC and the UN MTC, insofar as it has been customary, Contracting States may determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits. Notwithstanding, the adopted method shall be such that the result shall be in accordance with the principles contained in this Article.

Criteria commonly used to allocate profits according to apportionment are grouped by the OECD into three main categories, i.e. those which are based on the receipts of the enterprise, its expenses or its capital structure. The first refers to turnover or commission proxies, the second focuses on wages and the third on the proportion of the total working capital to be allocated to each branch[43].

That said, the provision is, by far, the one that has been removed most by Ibero-American countries, considering that the OECD 2008 Model has been almost always the point of departure within negotiations of the content of art.7. A significant number of DTCs dismiss art.7.4 of the mentioned models, while maintaining the rest of the OECD 2008 MTC provisions intact -except for art.7.6, which is completely useless if art.7.4 is not

[43] OECD 2008 MTC Commentaries, par.54.

included-[44]. Also, DTCs that depart to some extent from the OECD 2008 MTC dismiss this clause from their wording[45].

The disregard of such a clause is fairly meaningful, as its configuration as established in the models leads to severe interpretation issues. On the one hand, the provision seems to establish an exception to the use of the "functionally separate enterprise" notion envisaged in art.7.2, as it enables the use of apportionment methods as long as it is customary in the State willing to apply them. These methods require the use of allocation criteria that are applied irrespective of whether the outcome matches that of the separate enterprise notion; indeed, this is why an express authorization in the text of the Convention is needed to use these methods to attribute profits at a DTC level. Otherwise, it would not be possible due to the fact that both apportionment and the separate enterprise principle are dissimilar.

Notwithstanding, the last requisite for art.7.4 to be applied goes against the mentioned rationale, as it requires that the result of applying apportionment must be in line with the outcome of the functionally separate enterprise notion, which only in rare occasions will coincide. To put it in other words, if the outcome of each methodology differs, then the latter will prevail. This means that art.7.4 is pointless, as it will always entail that the attribution of profits to PEs will be the result of applying the separate enterprise principle enshrined in art.7.2.

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[44] Treaties of **Argentina** (with Brazil and France), of **Brazil** (with Argentina, Belgium, Canada, Chile, Czech Republic, Denmark, Ecuador, Finland, France, Hungary, India, Israel, Italy, Japan, South Korea, Luxembourg, Netherlands, Norway, Peru, Philippines, Portugal, Slovak Republic, South Africa, Spain, Sweden, Trinidad and Tobago and Turkey), of **Chile** (with Brazil, China, Japan, South Korea, New Zealand, Spain and Sweden), of **Colombia** (with Canada, South Korea, Portugal and Spain), of **Costa Rica** (with Spain), of **Dominican Republic** (with Canada), of **Ecuador** (with Brazil, Germany and South Korea), of Mexico (with Peru and Turkey), of **Paraguay** (with Taiwan), of **Peru** (with Brazil, Canada, South Korea, Mexico and Portugal), of **Portugal** (with Algeria, Andorra, Brazil, Bulgaria, Canada, Cape Verde, Colombia, France, Greece, Hungary, Ireland, Japan, South Korea, Mozambique, Norway, Peru, South Africa, Spain, Sweden, Turkey and the United States), of **Spain** (with Albania, Algeria, Andorra, Barbados, Belarus, Brazil, Bulgaria, Canada, Chile, Colombia, Costa Rica, Egypt, Estonia, Georgia, Germany, Greece, Italy, Kazakhstan, South Korea, Kyrgyzstan, Latvia, Lithuania, Moldova, Morocco, Netherlands, Norway, Oman, Portugal, Russia, Saudi Arabia, Serbia, Singapore, South Africa, Sweden, Tajikistan, Trinidad and Tobago, Turkey, Turkmenistan, Ukraine, Union of Soviet Socialist Republics, United Arab Emirates, United Kingdom, Uruguay, Uzbekistan and Venezuela), of **Uruguay** (with Finland, South Korea, Malta, Romania, Singapore, Spain and the United Kingdom) and of **Venezuela** (with Spain).

[45] Treaties of **Argentina** (with Australia, Canada, Finland, Italy, Norway, Russia, Spain, Sweden and the United Kingdom), of **Brazil** (with Austria, Mexico, Ukraine), of **Chile** (with Australia, Canada, China and the United Kingdom), of **Ecuador** (with Canada, Spain and Uruguay), of **Mexico** (with Australia, Brazil, Canada, New Zealand), of **Portugal** (with India, Senegal and the United Kingdom), of **Spain** (with Argentina, Australia, Belgium, Ecuador, India, Indonesia, Kuwait, Malaysia, New Zealand, Tunisia), of **Uruguay** (with Ecuador and Vietnam) and of **Venezuela** (with Canada, Saudi Arabia, Trinidad and Tobago and the United Kingdom).

Albeit the aforementioned derives from the plain reading of art.7.4, the OECD 2008 MTC Commentaries try to reconcile the recognition of the applicability of apportionment methods and the principles underlying art.7. Despite it is considered that formulaic methods differ from the one envisaged in paragraph 2, it is necessary to "produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis"[46]. Such conflict can only be solved by affirming the prevalence of the outcome derived from the functionally separate enterprise fiction, as explained in the prior paragraph.

All the departures from the wording of art.7.4 within the Ibero-American DTC network are drafted to express the same concern, i.e. the fact that the lack of information in a given case cannot be an impediment to determine the taxable base, even if such is performed by exercise of a discretion or the making of an estimate[47]. By means of illustration, one may quote art.7.4 of the DTC signed between Venezuela and Malaysia:

> "If the information available to the competent authority is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, nothing in this Article shall affect the application of any law of that State relating to the determination of the tax liability of a person by the exercise of a discretion or the making of an estimate by the competent authority, provided that the law shall be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article".

A common denominator is again present, namely, that law must be applied consistently with the principles of art.7. The main difference in wording lies in the fact that, in some DTCs "the result" must be in line with such principles[48], while in others, it is stated that law shall be applied, "so far as the information available permits", consistently with the principles of this Article[49].

As happens with the original wording of art.7.4, this clause does not add new elements to be considered as regards the application of art.7 and the separate enterprise principle. To put it in other words, should the mentioned deviations not exist, the outcome would be the same. It is true that the separate enterprise principle entails a fiction by which profits attributable to a PE -yet another tax fiction- are the ones an independent party would have obtained in comparable conditions and thus, facts are relevant not only to ascertain the applicability of the rule but also to determine the outcome of it. Notwithstanding, despite

[46] OECD 2008 MTC Commentaries, par.54.

[47] Treaties of **Argentina** with Australia, **Chile** with Malaysia, **Cuba** with Vietnam, **Mexico** with Australia, **Spain** (with Australia, Belgium and Malaysia) and **Venezuela** (with Czech Republic, Indonesia, Kuwait, Malaysia, Norway and the United States)

[48] Treaties of **Spain** with Belgium, and of **Venezuela** (with Czech Republic, Indonesia and Norway).

[49] Treaties of **Chile** with Malaysia, **Cuba** with Vietnam, **Spain** (with Australia and Malaysia) and of **Venezuela** (with Kuwait, Malaysia and the United States).

the fact that the lack of information may cause difficulties in applying the methodology described *supra*, it would be unusual not to have a minimum factual basis derived from, at least, evidence assessment by the tax authorities on the essential elements to attribute profits according to the separate enterprise notion, being it always the guiding principle to be followed. Thus, as the outcome must respect such guidance, a modified art.7.4 clause referred to the lack of information is merely redundant.

The only provision that may entail additional interpretation issues is the one present in the DTC signed between Argentina and Australia, that states the following (art.7.5)[50]:

> "Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person, including determinations in cases where the information available to the competent authority of that State is inadequate to determine the profits to be attributed to a permanent establishment, provided that law shall be applied, *so far as it is practicable to do so*, consistently with the principles of this Article" (emphasis added).

Here, the domestic method to calculate the profits attributable to a PE could differ from the separate enterprise notion envisaged in art.7, but in this case, the former prevails over the latter due to the emphasized formulation, i.e. the domestic method must respect *so far as it is practicable to do so* the separate enterprise principle, but if it is not possible due to the very nature of the domestic method, such rules would prevail.

Once explained the particular situation of apportionment methods, it is easier to understand why this section follows the one referred to the allocation of profits through the "functionally separate enterprise" notion, i.e. because both in those DTCs that include a clause identical to art.7.4 of the pre-2010 OECD Model and those that remove it from the content art.7, follow at the end of the day the same rationale, because according to the configuration of the mentioned provision, apportionment methods are not applicable, being the only exception in the whole DTC network the last mentioned one (Argentina-Australia), due to its particular wording. This is the reason why this section was not included within the "model deviations" one, because despite the fact that many of the mentioned DTCs strictly entail a model deviation, its impact is by all means inexistent.

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[50] An identical wording may be found in the protocol referred to the DTC signed between Mexico and Australia.

3. MODEL DEVIATIONS

3.1. FORCE OF ATTRACTION

The force of attraction rule deviates from a strict attribution of profits in accordance with the separate enterprise notion as envisaged in the OECD 2008 MTC. The UN 2011 MTC, as well as the prior UN models, include such clause embedded in art.7.1 as to widen taxing rights of the source State on what regard business income.

Essentially, the force of attraction rule is designed to attribute taxing powers to the State in which a permanent establishment operates, on the profits derived from economic activities of the same or similar kind as those effected through that permanent establishment. The main reasons to introduce such a clause, apart from the widen of taxing rights of the jurisdiction in which a PE exists, are tax avoidance and administrative issues[51], derived from the fact that the attribution of profits to permanent establishments according to functions performed and the activities carried out by the PE usually presents significant difficulties that may be soften through a force of attraction rule. Notwithstanding, this alleged simplification will not always be such, because similar interpretation problems arise within the framework of these rules, e.g. to determine when a sale or an economic activity is similar to that performed by a PE, or to ascertain whether the taxpayer conducts business in a given jurisdiction by splitting functions alongside the PE and the head office to obtain tax advantages.

Many DTCs in the Ibero-American network include such a clause. Especially, Mexico and Argentina display a consistent treaty policy in that sense. All of the force of attraction clauses are limited ones, which mean that not all the profits derived in a certain jurisdiction are attributable to the PE, but only those that can be connected with the activities the PE perform or the sales that are made through it. To ascertain such elements, it is important to focus on the first step of the AOA methodology, namely, in determining whether the PE perform functions that are comparable to those performed by the enterprise in the same State but not through the PE.

Some of the DTCs contain the clause as drafted in the UN Model Convention[52], but most of them depart from its wording[53]. Detected deviations may be classified into the following categories:

[51] SASSEVILLE, J.; VANN, R. (2014) "Commentary on article 7", section 1.1.2.2.

[52] Treaties of **Argentina** (with Belgium, Canada, Finland, Netherlands, Norway, Russia, Spain and Sweden), of Cuba (with Venezuela and Vietnam), of **Ecuador** (with Uruguay), of **Panama** (with Vietnam), of **Portugal** (with Indonesia), of **Spain** (with Argentina, India, Indonesia, Nigeria and Thailand), of **Uruguay** (with the United Arab Emirates and Vietnam) and of **Venezuela** (with Cuba, Indonesia, Russia and Saudi Arabia)

[53] Treaties of **Argentina** (with Australia, Denmark, Spain and the United Kingdom), of **Chile** (with Mexico), of **Ecuador** (with Mexico), of **Mexico** (with Australia, Bahrain, Barbados, Belgium, Canada,

3.1.1. Limited force of attraction on (only) sales. Removal of art.7.1.c) UN MTC.

The first deviation from the UN Model clause simply consists in the removal of letter c)[54], i.e. it does not add variations to the wording itself, but just erase one part of the modelled provision. This entails that, apart from the profits attributable to the PE itself, only profits derived from "sales of goods or merchandise of the same or similar kind as those sold through that permanent establishment" -letter b)-, but not those profits derived from other activities -due to the erase of letter c-, may be taxed in the State in which the permanent establishment lies[55].

This means that profits derived from economic activities different from sales are excluded from the scope of the limited force of attraction rule. For instance, if a PE sells computers, but the after-sales service is performed by the head office, profits derived from such service cannot be taxed by the source State through the force of attraction rule, if designed as stated in this subsection.

What's more, if the goods or merchandise sold differ from the ones that are being sold through the PE -are not of the same or similar kind-, the limited force of attraction rule would not apply either. This may entail interpretation issues as to define when such a dissimilarity exists. One may say that, for instance, if a PE sells computers and the head office sells office equipment in the country in which the PE is present, both are selling different goods, but it is also true that computers may form part of regular office gadgetry. The wording of the limited force of attraction rule may be thus interpreted differently, depending on the taxing powers one may prefer to attribute to the jurisdiction in which the PE is present. In order to solve such issues, probably the most balanced solution would be for the States to consult between each other on the similarity of the goods sold[56].

3.1.2. Limited force of attraction on the negotiation and conclusion of contracts.

Czech Republic, Denmark, Estonia, Finland, France, Hong Kong, Iceland, Indonesia, Israel, Latvia, Lithuania, Malta, New Zealand, Norway, Poland, Portugal, Romania, Russia, South Africa, Sweden, Ukraine, United Kingdom, United States and Uruguay), of **Panama** (with Barbados), of **Portugal** (with Venezuela), of **Spain** (with Philippines) and of **Venezuela** (with Barbados, Czech Republic, Denmark and Norway).

[54] Art.7.1 letter c) of the UN Model Convention states that the source jurisdiction may tax "other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment".

[55] Treaties of **Argentina** (with Spain), **Mexico** (with Belgium, Czech Republic, Ecuador, Indonesia, New Zealand, Romania and Ukraine) of **Ecuador** (with Mexico), **Portugal** (with Venezuela), **Spain** (with Argentina) and **Venezuela** (with Barbados, Czech Republic and Portugal).

[56] For instance, this concern is expressly contemplated in the wording of the DTC signed between Spain and the Philippines, art.7.1 *in fine*, stating that "the competent authorities of the Contracting States shall consult each other on the similarity of goods sold or business transactions".

This category onwards reflects changes on the wording of the UN force of attraction provision. In this case, taxing powers are expanded beyond the breadth of the attribution to permanent establishments to cover specific cases not provided on the referred model, in which the permanent establishment takes an active and substantial part in the negotiation and conclusion of contracts entered into by the enterprise. In these cases,

> "[…] there shall be attributed to the permanent establishment such proportion of the profits of the enterprise arising out of those contracts as the contribution of the permanent establishment to those transactions bears to that of the enterprise as a whole".

It is certainly striking to notice the resemblance of this provision, which is present in the DTCs signed between United Kingdom with **Argentina** and **Mexico**, with the concerns expressed during the BEPS project on the avoidance of the PE status[57]. But even more surprising, the first mentioned DTC entered into force in 1997, and the second one in 1994, more than 20 years before the implementation of the new permanent establishment definition in the Multilateral Convention[58]. Curiously enough, these provisions do expand significantly the taxing powers of the source State, if compared with the attribution of profits resulting from the new PE definition that derived from the BEPS project[59]. In this latter scenario, the new PE definition does not lead to a higher attribution of income to the PE, but only expands the limits of the PE concept. It is indeed complicated to see how a broader delineation of the dependent agent notion serves the purpose of tackling base erosion and profit shifting, if one takes into account that the dependent agent is already a resident taxpayer either under the CIT or the PIT of the jurisdiction in which agency activities are being performed. Thus, the outcome in revenue terms remain the same. On the other hand, in the commented provision, a direct relationship between the actions of the agent and the resulting profits is established and therefore, a higher attribution of profits is allowed.

3.1.3. Limited force of attraction rule combined with an objective escape clause.

[57] See OECD 2014 *Public Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status*. OECD 2015 *Revised Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status.* OECD 2015 *Final Report. Preventing the Artificial Avoidance of Permanent Establishment Status.*

[58] See art.12 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

[59] See the figures expressed in Example 1 of the BEPS 2016 *BEPS Action 7. Additional Guidance on the Attribution of Profits to Permanent Establishments*, in par.21 et seq. where it is illustrated that the State in which the PE is present, will be entitled to tax almost the same amount of income as if the PE was not to exist.

The next category of deviations refers to those provisions in which a limited force of attraction rule that refer to sales and other economic or business activities, is accompanied with an objective escape clause, i.e. if it is proven that such sales or activities could not have been undertaken by the permanent establishment in the ordinary course of its activities, resulting profits will not be attributed to the PE[60].

The DTCs fitting into this category place on the taxpayer the burden of proving that sales or activities could not reasonably have been undertaken by that permanent establishment. The only exception is the DTC signed between **Argentina** and Australia, which employs a neutral form:

> "*If it may reasonably be concluded* that those sales or business activities would not have been made or carried on but for the existence of that permanent establishment or the continued provision by it of goods or services" (emphasis added).

The word "reasonably" is also mentioned in these DTCs -being the only exception the one signed between **Mexico** and Sweden"- probably because it is uncontroversial that the burden of proving the dissimilarity in the activities performed by the permanent establishment and other activities may be difficult to achieve in some situations. The most controversial issue to be resolved in each case consists in accurately determine the element of comparison, as commented before[61].

3.1.4. Limited force of attraction rule combined with a subjective escape clause.

Some DTCs also contain an escape clause embedded on the force of attraction rule, but referred to the intention of the taxpayer when designing its foreign direct investment strategy. Specifically, it is required that sales or economic activities have been carried out for reasons other than obtaining a benefit under the Convention[62]. In this case, it seems that the benefit would be the removal of taxing powers by the source State when the taxpayer conducts sales or economic activities that cannot be attributed to an existing PE as, *prima facie*, resulting profits will not be taxable by the source State, should a force of attraction not exist.

The burden of the proof is again placed on the side of the taxpayer, with the sole exception of the Treaties of **Mexico** with Estonia and Latvia. The test focus on whether reasons

[60] Treaties of **Argentina** (with Australia and Denmark) and of **Venezuela** (with Denmark and Norway), all referring to bussiness and comercial activities, being the DTC signed between **Mexico** and Sweden an exception, as it refers to property alienation.

[61] See section 3.1.1.

[62] Treaties of **Chile** (with Mexico), of **Mexico** (with Australia, Bahrain, Barbados, Canada, Chile, Denmark, Estonia, Finland, Greece, Hong Kong, Iceland, Israel, Latvia, Lithuania, Malta, Norway, Poland, Portugal, Russia, South Africa, United States, Uruguay), of **Panama** (with Barbados), of **Portugal** (with Mexico)

other than to obtain tax savings in the source State exist that may justify the adopted structure. This requirement is placed alongside the already commented analysis on the need for sales or economic activities to be similar to those performed by the existing PE in the source jurisdiction.

The very UN MTC Commentaries reflect that some of its members considered that the limited force of attraction rule should not be applied when an enterprise has legitimate business reasons for choosing not to carry out sales or business activities through its PE[63]. Here, no such terms as “main”, “one of the main” “principal” or “essential” reasons are used and therefore, the degree of importance of the business reason seems not to be relevant, as long as there is at least one that may help to explain the structure adopted by the taxpayer.

3.2. LIMITATION OF EXPENSES

None of the OECD MTC versions contain restrictions on the recognition of expenses to be attributed to the PE in order to determine its profits. Notwithstanding, at the level of the Commentaries and corresponding reports on the subject matter, the OECD did introduce some limitations, allegedly deriving from the interpretation of the wording of art.7 itself, despite the fact that art.7.3 of the OECD pre-2010 MTC and prior versions determine that “there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment” as if it were a distinct and separate enterprise. Our understanding of a unified interpretation of the functionally separate enterprise notion present in every DTC Model, necessarily demands that every expense that would be recognized to an enterprise in a given jurisdiction, should also be recognized at the level of the determination of the profits to be attributed to the PE via art.7.

That said, the UN MTC does expressly contain a limitation on the recognition of deemed expenses derived from internal dealings by the PE and its head office, and the PE with other PEs within the same enterprise. Specifically, payments made or received by the PE in this context in respect of amounts referred to (1) royalties, fees or other similar payments in return for the use of patents or other rights, (2) commission payments, for specific services performed or for management and (3) interest payments -except in the case of financial institutions-. A considerable number of DTCs contain this provision[64],

[63] UN MTC Commentaries on art.7, par.7.

[64] Treaties of **Brazil** (with Venezuela), of **Cuba** (with Austria, Venezuela and Vietnam), of **Mexico** (with Austria, Bahrain, Barbados, Belgium, China, Czech Republic, Denmark, France, India, Indonesia, Latvia, Netherlands, Slovak Republic, South Africa, Spain, Ukraine and Uruguay), of **Panama** (with Vietnam), of **Portugal** (with Kuwait, Saudi Arabia, Senegal, Venezuela and Vietnam), of **Spain** (with China, India, Indonesia, Mexico, Thailand and Vietnam), of **Uruguay** (with Ecuador and Mexico) and of **Venezuela** (with Austria, Barbados, Brazil, China, Cuba, Denmark, Indonesia, Korea, Kuwait, Norway, Portugal, Russia, Saudi Arabia, United Arab Emirates and Vietnam).

but also deviations based on it may be found in the Ibero-American DTC network. These may be divided in the following subsections:

3.2.1. Limitation only referred to expenses, but not to income received from internal dealings

The first departure from modelled provisions takes as reference the text of the UN MTC. As expressed, not only expenses are limited, but also the computation of gross income, as internal dealings favoring a PE are not recognized either. It has to be highlighted that a number of Ibero-American DTCs that contain a clause regarding restrictions on expenses, do not follow the modelled UN provision, mainly to remove the restriction on the attribution of profits derived from internal dealings that imply the recognition of amounts charged by the PE, thus entailing an increase of its taxable base[65].

The mentioned removal implies to broaden taxing rights from the side of the jurisdiction of the PE vis-à-vis those that would arise should the modelled UN provision have been adopted. Thus, notional payments are recognized, but not the ones that imply lowering the taxable base of the PE.

3.2.2. Limitation to equate the recognition of expenses of enterprises and PEs

A second group of deviations is referred to those DTCs that include a clause similar to that of art.7.3 OECD pre-2010 MTC, but do not allow deductions for expenses which would not be deductible if the PE were a separate enterprise[66]. This add-on is adequate to align the determination of the taxable base of the PE at the domestic level and the quantitative limit imposed on the PE jurisdiction at the DTC level. This is so because the modeled OECD MTC provision may lead to interpretative issues.

The wording of the modelled provision, stating that "there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment", may lead to consider that at the DTC level, no limits on the recognition of expenses can be imposed. This approach entails at the end of the day to lower the limit of the amount that the source State is entitled to tax, as the recognition of more expenses lead to a lower amount to be taxed at source.

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[65] Treaties of **Brazil** (with Ukraine), of **Chile** (with Canada), of **Cuba** (with Qatar), of **Ecuador** (with Mexico), of **Mexico** (with Brazil, Canada, Finland, Iceland, Ireland, Israel, South Korea, Norway, Poland, Romania, Russia, Singapore, Sweden, United Kingdom and the United States) of **Portugal** (with Denmark) and of **Venezuela** (with Canada, Trinidad and Tobago, United Kingdom and the United States).

[66] Treaties of **Portugal** (with Austria, Belgium, Finland and the United Kingdom).

On the other hand, to limit the expenses a PE can deduct at the DTC level would be meaningless if these limitations are not aligned with those of domestic law, because then, the limit imposed by the DTC will be higher than the amount resulting from the calculation of the taxable base at the domestic level.

3.2.3. Limitation to link the recognition of expenses to that of domestic law

The third group of deviations also departs from the wording of art.7.3 OECD pre-2010 MTC. Here, the introduced nuance refers to the fact that expenses must be recognized at the domestic law level, for them to be recognized in the DTC context[67]. As happens with the prior commented deviation, i.e. the one referred to the recognition of expenses only if these are authorized for enterprises, these provisions aim to align the treatment of expenses at the domestic and the DTC level. That said, the difference between both deviations lies in the fact that a restriction or recognition of expenses exclusively referred to the determination of the taxable base at the level of the PE within domestic law is possible in the current commented category, but not in the prior one -that align expenses recognized for enterprises with those recognized for PEs at the domestic level-.

This fact is relevant, since DTCs normally prevent the contracting States from discriminating a PE vis-à-vis resident enterprises[68], but not the other way around, i.e. a jurisdiction may recognize more expenses to PEs than to resident enterprises.

A variation of the commented deviation may also be found in some specific DTCs. It refers to a wording in which the domestic law is mentioned, but it seems that no specific outcomes may be derived from such reference. For instance, art.7.3 of the DTC signed between **Spain** and **Ecuador** states:

> "In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere. Such *expenses must be substantiated in accordance with the law* of the Contracting State in which the permanent establishment is situated" (emphasis added).

[67] Treaties of **Colombia** with India, of **Ecuador** with Canada, of **Mexico** (with Lithuania and Qatar), of **Panama** with Qatar, of **Portugal** with India, of **Uruguay** with India and of **Venezuela** with Qatar. See also the 2017 Protocol signed between **Chile** and Peru.

[68] See art.24.3 OECD MTC, art.24.3 UN MTC, art.24.2 US MTC: "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities".

A similar formula may be derived from art.7.3 of the DTC signed by **Mexico** with Kuwait, and the United Arab Emirates:

> "In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere, *taking into consideration any applicable law or regulations*" (emphasis added).

The three mentioned DTCs are the ones that display ambiguity in the commented sense. It is hard to ascertain the role the mentioned variations may have within art.7.3. Probably the most sensible approach would be to examine the issue from a burden of the proof perspective. One may sustain that expenses must be substantiated in accordance with the requirements envisaged in the domestic law of the contracting States, despite the fact that such a reference is redundant, because without it, the result would be the same: DTCs are silent regarding burden of the proof issues and therefore, domestic law will necessarily be observed to solve them.

On the other hand, one may query whether references to domestic law are made to link the recognition of expenses at the domestic level and at the DTC level, as the prior commented variations to the modelled provisions do. Notwithstanding, neither of the two quoted provisions state so, but only that one must take domestic law into consideration, and that one must substantiate expenses in accordance with it. This does not mean that at the DTC level, expenses are to be constrained by virtue of domestic law and therefore, one cannot derive such a mandate if it is not specifically provided in the text of the Convention.

3.2.4. Combined variations

There are five clauses found in the Ibero-American DTC network that combine the aforementioned variations, namely:

- Art.7.3 of the DTC signed between **Mexico** and Australia: it contains a clause similar to that on limitation only referred to expenses, but not to income received from internal dealings. The existing nuance is that it also requires for payments made by the PE have to be also deductible if the PE were a resident enterprise.
- Art.7.3 of the DTC signed between **Mexico** and Romania: it also contains a clause similar to that on limitation only referred to expenses, but not to income received from internal dealings. This time, such clause is accompanied by the following caveat: "These provisions shall be applied in accordance with the domestic laws of the Contracting State in which the permanent establishment is situated".
- Art.7.4 of the DTC signed between **Venezuela** and the United States: this provision is built in accordance with the wording of art.7.3 UN MTC, but it

removes the exception on the restriction of notional payments of interests that permitted PEs of banks to deduct such amounts. Also, it is clearly stated that a contracting State might impose restrictions on deductions, as long as these limitations are coherent with the concept of net income. Such mandate might be labelled as self-serving, because the idea of net income is necessarily defined by the domestic tax laws of each jurisdiction.

- Art.7.3 of the DTC signed between **Portugal** and Denmark: the wording of this provision is almost identical to the one of art.7.3 UN MTC. The only change regards the fact that, for expenses to be authorized, they should be deductible if the PE were a separate enterprise. Please notice that in a previous subsection a reference was made to limitation of expenses in accordance to those separate enterprises could deduct, but introduced within a clause similar to OECD pre-2010 MTC. Here, the wording departs from art.7.3 UN MTC.
- Art.7.3 of the DTC signed between **Cuba** and Qatar: this is a mixed provision, in the sense that Qatar adopts an OECD approach and lets every expense connected to the PE, while for Cuba, a restriction identical to that enshrined in art.7.3 of the UN MTC is envisaged.

3.3. DEVIATIONS REFERRED TO THE SCOPE OF ART.7

From now on, all the deviations that will be analyzed refer to aspects alien to the wording of both the OECD MTC and the UN MTC. The first category of such departures refers to the scope of the article in which business profits are governed, mainly to include in its scope income derived from the use of particular structures.

It is worth mentioning that these provisions seem to derive not from concerns displayed by Ibero-American countries but their counterparts. For instance, the four DTCs that Australia has signed with Ibero-American partners include the following clause[69]:

"Where:

a) a resident of a Contracting State is beneficially entitled, whether directly or through one or more interposed trust estates, to a share of the business profits of an enterprise carried on in the other Contracting State by the trustee of a trust estate other than a trust estate which is treated as a company for tax purposes; and
b) in relation to that enterprise, that trustee would, in accordance with the principles of Article 5, have a permanent establishment in that other State,

the enterprise carried on by the trustee shall be deemed to be a business carried on in the other State by that resident through a permanent establishment situated

[69] Treaties of **Argentina** with Australia, of **Chile** with Australia, of **Mexico** with Australia (Protocol) and of **Spain** with Australia. Also, the DTC signed between Spain and New Zealand include an identical clause.

therein and that share of business profits shall be attributed to that permanent establishment".

Also, in three articles signed by Austria, a provision referred to silent partnerships ("stille gesellschaft") may be found[70]:

> "The provisions of this Article are also to be applied to income derived by a silent partner from his participation in a silent partnership (stille Gesellschaft) under Austrian law".

Germany also included the following clause referred to partnerships in two DTCs[71]:

> "This Article shall also apply to income from participation in a partnership. It shall further apply to remuneration received by a partner from the partnership for activities in the service of the partnership and for the granting of loans or the provision of assets, where such remuneration is attributable under the tax law of the Contracting State in which the permanent establishment is situated to the income derived by a partner from that permanent establishment".

Finally, the following clause was included in the DTC signed between **Spain** and Tunisia:

> "Income derived by a resident of a Contracting State from an "association en participation", a "société de fait" or a company subject to the obligatory fiscal transparency ruling, who is operating in the other Contracting State, may be taxed in that other State".

Two common issues may arise within the framework of these clauses. The first one refers to their compatibility with the provisions referred to the subjective scope of the DTC itself, typically embedded in arts 1 and 4. If a silent partnership is not entitled to access the benefits of the DTC due to the content of these articles, the provisions contained in art.7 would not be applicable. The second one refers to the effect of this clause with respect to the other provisions of the DTC. Albeit art.7 of the mentioned DTCs contain a clause that regard this provision as subsidiary vis-à-vis articles that envisage a specific treatment for different items of income, the analyzed clauses in principle do not take precedence over the rest of the articles referred to the allocation of taxing powers.

3.4. INSURANCE CLAUSES

Insurance clauses embedded in art.7 are quite varying, depending on their scope and limitations on the source State power to tax. One feature that all these clauses share is that

[70] Treaties of **Brazil** with Austria, of **Portugal** with Austria and of **Spain** with Austria.

[71] Treaties of **Costa Rica** with Germany and of **Uruguay** with Germany.

they confer broader taxing powers to the source State if compared with the inclusion of an insurance clause within the definition of the "permanent establishment" concept, as the attribution of the power to tax income to the source has not to be necessarily connected to the economic activities performed by the PE.

Hereby, the different types of classes will be brought into discussion, from the ones that do not impose limits to the source State to those that establish a quantitative limit to source State taxing powers.

Those DTCs that ensure unlimited taxing powers to the source State are few[72], and some include a clause that oblige the States to consult each other in case an amendment of the provision is needed due to a change on their domestic law that entail significant variations in the tax treatment of the income derived from insurance activities[73].

The DTCs signed by **Argentina** with Norway and Italy limit source taxing powers to "insurance covering property situated in the other Contracting State or persons which are residents of that other State, at the time of the conclusion of the insurance contract". Also, the provision embedded in each Convention has a singularity. The former applies also to reinsurance, "but only where reinsurance premiums are paid by an insurance enterprise which is a resident of that other State". The latter states that when the insurance contract refers to persons which are residents of that other State, the payer of the premium has to be also a resident of the very same jurisdiction, i.e. the source one.

A somehow particular couple of provisions that are worth mentioning are contained in the DTCs signed by **Mexico** with Australia and New Zealand. The design of these clauses is, to say the least, peculiar. The one agreed with New Zealand states the following:

> "Nothing in this Article shall affect any provisions of the laws of either Contracting State at any time in force as they affect the taxation of any income or profits from any form of insurance. For the purposes of the application of this paragraph, an insurance enterprise of New Zealand shall, except in regard to reinsurance, be deemed to have a permanent establishment in Mexico if it collects premiums in Mexico or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 8 of Article 5 applies".

First, it is stated that nothing in art.7 will preclude the source State to tax the income derived from insurance -in the DTC with Australia, the scope is restricted to "insurance with non-residents"-. But after granting unlimited rights to tax to the source State, it is stated that "for the purpose of this paragraph", an insurance permanent establishment definition is provided when Australian or New Zealand companies perform this business in Mexico. The purpose of the ampleness of the scope of the permanent establishment

[72] Treaties of **Argentina** (with Canada and Russia) and **Chile** with the Czech Republic.

[73] Treaties of **Argentina** with Australia, of **Spain** with Australia and of **Venezuela** with Saudi Arabia.

definition referred to the insurance business remain unknown, because the very paragraph in which such definition is provided, states that no limits on the taxing powers of the source State are imposed. As the concept of permanent establishment becomes thereby irrelevant, it is hard to see the usefulness of the second part of the mentioned paragraphs.

Another set of DTCs grant taxing rights to the source State, but limited in accordance with the gross amount of the premiums derived from insurance or reinsurance covering property situated in the other Contracting State or persons which are residents of that other State at the time of the conclusion of the insurance contract, ranging from 2,5% of this amount[74], to 5% (for reinsurance premiums) or 10% (rest of the premiums) -unless the premium is attributable to a PE-[75], to a 10%[76]. It must be highlighted that the limit on source taxation refers exclusively to premiums.

3.5. ANTI-DEFERRAL CLAUSES

A further category of provisions refers to the taxation of business income attributable to a PE even when payments are deferred until it ceases to exist. In this sense, these clauses do not establish a timing attribution criterion, but determine that irrespective of the timing method established in the domestic law of the jurisdiction in which the PE lies, the income may be taxed by this State, even if in the fiscal year to which the income is considered to be obtained by the PE, it does not exist anymore.

It is noticeable that these clauses are quite similar in their construction, but their scope vary. A first category that may be mentioned is that of provisions applicable whenever a PE obtains income, irrespective of the label this income may have. This is, the defined mandate is extensible not only to art.7, but also to provisions impacting PEs, such as those included in articles referred to the tax treatment of dividends, interests, royalties, capital gains, independent personal services and other income[77].

Other clauses are only applicable within the realm of art.7, because they start with the formula "In applying paragraphs 1 and 2 of this Article…" and so, the anti-deferral rule embedded in art.7 would not be applicable to other articles[78].

3.6. DEFINITION OF THE TERM "PROFITS"

[74] Treaties of **Argentina** (with Belgium, Denmark, Finland, the Netherlands, Spain, Sweden, Switzerland and the United Kingdom).

[75] Treaties of **Argentina** with Chile and **Chile** (with Argentina and Australia).

[76] Treaty of **Spain** with New Zealand.

[77] Treaties of **Chile** with France, of **Mexico** with Australia and of **Venezuela** with the United States.

[78] Treaties of **Chile** with the United Kindgom and of **Mexico** (with France, Italy and the United Kingdom).

Some DTCs within the Ibero-American network contain a specific definition of the term "profits", "business profits" or "industrial or commercial profits", which will be relevant to define the scope of art.7. Some of them do not add significant variations nor clarifications to the notion that may be inferred from the wording of the mentioned article. One may mention the following two provisions in that regard:

- Art.7.4 of the DTC signed between **Venezuela** and Saudi Arabia: "the term 'business profits' includes, *but is not limited to* income derived from manufacturing, mercantile, banking, insurance, from the operation of inland transportation, the furnishing of services and the rental of tangible personal movable property. Such a term does not include the performance of personal services by an individual either as an employee or in an independent capacity" (emphasis added).
- Art.7.5 of the DTC signed between **Portugal** and the United Kingdom: "the term 'industrial or commercial profits' means income derived by an enterprise from the conduct of a trade business, *including* income derived by an enterprise from the furnishing of services of employees or other personnel and dividends, interests or royalties effectively connected with a trade or business carried on through a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, but the term does not include dividends, interests or royalties not so connected; nor does it include remuneration for personal (including professional) services" (emphasis added).

Should these provisions not exist, the scope of the DTCs would not vary, as both include the regular subsidiarity clause that turns art.7 applicable when none of the provisions of the DTC are. Also, the open formulation derived from using the expression "but is not limited to" and "including", is in line with the mentioned interpretation. Also, the second clause refer to dividends, interests and royalties effectively connected to a permanent establishment, in line with the clauses embedded in the articles referred to these items of income[79], that call back for art.7 to be applied.

On the other hand, the provisions that include relevant definitions on "profits" are:

- Art.7.1 *in fine* of the DTC signed between Spain and Kuwait: "payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial or scientific equipment, shall be deemed to be profits of an enterprise to which the provisions of this Article shall apply".
- Art.7.8 of the DTC signed between Mexico and Austria: "The term 'profits' as used in this Article includes the profits derived by any partner from his participation in a partnership and, in the case of Austria, from a participation in a sleeping partnership (*Stille Gesellschaft*) created under Austrian law".

[79] See arts.10.4 (dividends), 11.5 (interests) and 12.3 (royalties) of the OECD MTC and arts.10.4 (dividends), 11.5 (interests) and 12.4 (royalties) of the UN MTC.

- Art.7.8 of the DTC signed between Venezuela and Austria: "The term 'profits' as used in this Article includes the profits derived by any partner from his participation in a partnership".

The first clause brings payments derived from the use of, or the right to use, industrial, commercial or scientific equipment, out of the article referred to royalties[80], to be included as business profits in art.7. The usual qualification issues derived from the interpretation of such concepts may arise.

The other two clauses deal with income derived by the partners of a partnership. Notwithstanding, it must be mentioned that to state that the term "profits" include this type of income, does not preclude the application of the subsidiarity clause, i.e. other articles such as the one referred to dividends may take precedence if the income fits into its definition. Also, issues derived from the scope of the DTC may arise, as both articles state that "profits" comprise those derived by "any partner", without distinguishing whether the partner is to be considered a person resident of one of the contracting States or not. That said, it seems clear that in such a case, as the defined concept is the term "profits", such provision does not impact the articles referred to the scope of the DTC.

3.7. OTHER CLAUSES

Within art.7 of the DTCs that conform the Ibero-American network, one may find also clauses that cannot be classified within the above-mentioned categories. Therefore, this section is built upon heterogeneous provisions that do not display uniform characteristics. The low number of nuances that depart from the commented groups show that, generally speaking, Ibero-American countries tend not to display sporadic concerns on the article referred to business profits, being these a positive feature for the aggregated analysis of the DTC network. Due to their peculiar nature, each clause will be separately analyzed.

The first article to be analyzed refers to the taxation of business profits within Decision 578 of the Andean Community enacting an Income and Capital Tax Treaty, in force since January 1st, 2005, the members of which are **Bolivia**, **Colombia**, **Ecuador** and **Peru**. This Convention does not follow any known DTC Model. Indeed, the term "permanent establishment" is completely absent. According to article 6,

[80] Art.12.3 of the DTC signed between **Spain** and Kuwait: "The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematography films and works on films, tapes or other means of reproduction for use in connection with television or radio broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information (know-how) concerning industrial, commercial or scientific experience". Also, it is relevant to mention that art.12.2 establish a 5% maximum rate for royalties to be taxed at source.

> "Profits from business activities shall be taxable only in the Member Country in which they are derived […] where an enterprise carries on activities in two or more Member Countries, each of them may tax the profits generated in their territory, whereby each Country shall apply its internal rules regarding the determination of the taxable base as if it were a distinct, independent and separate enterprise, but avoiding double taxation in accordance with the rules of this Decision".

The mentioned article establishes a territorial rule to tax business profits, meaning that each country may tax business income that arises in its territory, in accordance with their domestic provisions. If an enterprise obtain income generated in two or more countries, the taxable base must be determined in accordance with rules equal to those that would apply to independent, separate enterprises. Double taxation must be avoided by applying the exemption method in those States which, in accordance with their domestic laws, have the right to tax the said income[81]. If two or more States consider that a specific income derives from their territory, they must consult each other as to achieve the purpose of the Convention, i.e. "to avoid double taxation on the same items of income or elements of capital at the community level"[82].

Article 7 of the DTC signed between **Argentina** and **Bolivia** also determines a territorial distribution of taxing powers. Specifically, it is stated that:

> "Profits resulting from business activities shall be taxable only by the Contracting State in which such business activities have been carried on. Where an enterprise carries on activities in both Contracting States, each of them may tax the income, gains or profits derived from within its territory".

Such clause pose interpretative problems, as the fact that triggers taxation is not to obtain business profits in a given territory -as happens within the already commented Andean Decision-, but to perform business activities in it. Depending on how one define such concept, results may vary. For instance, would sales to retailers performed through a webpage be considered as the performance of a business activity in the jurisdiction in which the buyers are located? Is it necessary for the enterprise to have some sort of physical presence in the State from which is deriving profits? Again, the concept must be determined in accordance with the domestic law of each State. In case of source-source conflicts, the Convention -which does not specify any method to eliminate double taxation, due to the fact that a territorial approach is adopted- states that the competent authorities of the Contracting States shall hold consultations with each other and exchange the information necessary for settling by mutual agreement any difficulty or doubt which may arise.

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[81] See art.3 of the Decision, named "tax jurisdiction".

[82] See art.20 of the Decision, named "interpretation and application".

The rest of the clauses are incorporated into modelled DTCs, but again, their particular and heterogeneous nature constitutes reason enough to study each one separately.

The DTC signed between **Argentina** and Germany contains a provision defining a limit on the attribution of profits to PEs in art.7.7:

> "Where a resident of the Federal Republic of Germany has a permanent establishment in the Argentine Republic, the Argentine tax on the profits of that permanent establishment, whether levied on the permanent establishment itself, on the above-mentioned resident of the Federal Republic of Germany or on both, *shall not exceed* the tax which is applicable under the Argentine law to profits of a company resident in the Argentine Republic plus 15% of these profits as calculated after the deduction of the above-mentioned tax on company profits" (emphasis added).

This provision is clearly at odds with the provision on non-discrimination of PEs enshrined in art.24.2[83]. One might raise the issue of which of the two clauses would prevail, as they seem in conflict, being probably the *lex specialis* criterion the one that should be considered in that case. Notwithstanding, this solution cannot be considered as adequate. One must take into account that the referred provision raises the limit on taxation of business profits established in art.7.2, but it remains to be considered as, in fact, a mere limit (see the added emphasis on the wording copied above). In this sense, the non-discrimination rule demands that, at the domestic law level, PEs receive a not less favorable treatment than domestic enterprises. Thus, the amount of taxes due at source calculated in accordance with the domestic law if this rule is honored will never arise above the referred 15%. It indeed will not raise even above the "profits of a company resident in the Argentine Republic". Therefore, this clause contains an empty mandate.

Art.7.8 of the DTC between **Chile** and Australia contains a rule comprising an agreed statute of limitation:

> "No adjustments to the profits attributable to a permanent establishment of an enterprise for a year of income shall be made by a Contracting State after the expiration of seven years from the date on which the enterprise has completed the tax filing requirements of that State for that year of income. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or willful default or where, within that period of seven years, an audit into the profits of the enterprise has been initiated by either State".

[83] Art.24.2 of the DTC signed between Argentina and Germany states: "The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourable levied in the other State than the taxation levied on enterprises of that other State carrying on the same activities".

Here, the contracting States have agreed on a common statute of limitations of 7 years applicable in cases of bona fide performance by the taxpayer. It seems clear that the existence of "fraud, gross negligence or willful default" will be considered by taking into account the domestic definitions of such concepts of the jurisdiction of the tax authorities.

As regards the calculation of the limitation term, this 7 years' period is independent from the domestic statute of limitations of each State, i.e. if due to domestic rules, the tax authorities are not allowed anymore to assess the taxpayer, the period contained in art.7.8 does not entail the extension of the domestic deadlines. Notwithstanding, it is important to note that the limitation period of 7 years will not be applicable in either jurisdiction if, before, the tax authorities of Australia or Chile initiate an audit, as the provision states *in fine*.

Chilean DTCs with Australia (art.7.9), Czech Republic (7.8) and the United Kingdom (7.8) contain a clause that prevents limitations contained in art.7 to be applied to taxation on profits attributable to a PE situated in Chile under both the First Category Tax and the Additional Tax. Also, the first two mentioned DTCs establish the requirement that the First Category Tax is fully creditable in computing the amount of the Additional Tax.

On the other hand, the **Chile**-UK DTC determines in its art.7.9 that nothing shall affect the application of the existing provisions of the Chilean legislation Decree Law 600 (Foreign Investment Statute) as they are in force at the time of signature of this Convention and as they may be amended from time to time without changing the general principle thereof.

Finally, art.7.8 of the DTC signed between **Uruguay** and Liechtenstein contains a clause on the elimination of double taxation that arises due to the taxing power the source State has over the income attributable to the PE:

> "Where, in accordance with paragraph 2, a Contracting Party adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting Parties and taxes accordingly profits of the enterprise that have been charged to tax in the other Party, the other Party shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting Parties shall if necessary consult each other".

The chosen method would be the credit of foreign taxes paid on the profits of the PE. This provision is relevant because art.23 establishes, for Liechtenstein residents, the exemption with progression method to be applied to active income. Here, probably the most reasonable solution would be to let the taxpayer choose which of the mentioned methods prefers to apply.